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FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE

FRSIC Consensus 10

How to Compute the Majority of the Benefits and Risks of Special Purpose Entity ("SPE") and what Constitutes the Residual Interest in the Case where there are Different Tranches of Risks?

Introduction

FRSIC Consensus 10 "How to Compute the Majority of the Benefits and Risks of Special Purpose Entity ("SPE") and what Constitutes the Residual Interest in the Case where there are Different Tranches of Risks?" was developed by the Financial Reporting Standards Implementation Committee ("FRSIC") and issued by the Malaysian Institute of Accountants ("MIA" or "Institute") on 31 July 2008.

The Consensus contained herein is issued as part of the Institute's initiatives to promote best practices in compliance with the highest standards in financial accounting.

FRSIC CONSENSUS 10**HOW TO COMPUTE THE MAJORITY OF THE BENEFITS AND RISKS OF SPECIAL PURPOSE ENTITY (“SPE”) AND WHAT CONSTITUTES THE RESIDUAL INTEREST IN THE CASE WHERE THERE ARE DIFFERENT TRANCHES OF RISKS?**

FRSIC Consensus is guidance issued by MIA and shall be regarded as best practice. It should be read in conjunction with the respective applicable accounting standards.

Members of MIA are expected to observe compliance to the consensus issued. In exceptional circumstances where departure is necessary, members shall be prepared to justify the departure.

FRSIC Consensus need not be applied to immaterial items. Nothing in the FRSIC Consensus is to be construed as amending or overriding the accounting standards or other statements adopted or issued by the MASB and other relevant laws.

The Issue

1. FRS 127 “Consolidated and Separate Financial Statements” requires the consolidation of entities that are controlled by the reporting entity. However, the Standard does not provide explicit guidance on the consolidation of special purpose entity (“SPE”).
2. IC Interpretation 112 “Consolidation – Special Purpose Entities” states that a special purpose entity (“SPE”) shall be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by the entity.

3. In addition to several circumstances indicated in paragraph 13 of FRS 127 “Consolidated and Separate Financial Statements” which result in control, IC Interpretation 112 (‘IC 112’) provides the following circumstances, which may indicate a relationship in which an entity controls an SPE:
 - a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE’s operation;
 - b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an “autopilot” mechanism; the entity has delegated these decision-making powers;
 - c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
 - d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.
4. In applying IC 112, the following issues require further clarification to ensure consistent application:
 - (i) How to compute the majority of benefits and risks of SPE?
 - (ii) What constitutes residual interest in the case where there are different tranches of risks?
5. A transfer of assets from an entity to an SPE may or may not qualify as a sale by that entity. This consensus does not address whether the assets transferred to the SPE qualify for derecognition from the book of the originator.

Consensus and Basis of Consensus

6. The following consensus is illustrated by examples provided in the Appendix:
 - (i) The majority of benefits and risks of SPE refer to the exposure to the majority of the variability of expected economic outcome. This principle is applied in various standards, for example, FRS 116 uses this principle when determining whether an exchange transaction has commercial substance.

When an entity measures the benefits and risks, it should take into consideration the entity’s exposure, before and after the transfer, with the variability in the amounts and timing of the cash flow of the transferred asset. This is illustrated in Example I. While it is acknowledged that there are more than one way of assessing risks and benefits, the method used in Example 1 is the most common method used in practice.

- (ii) For the purpose of assessing the “benefits” indicator especially in respect of “residual interest”, other tranches such as mezzanine tranche should be taken into consideration together with the Originator tranche in situation where the said tranche has sharing arrangement with the Originator tranche in respect of the “residual interest” being the remaining proceeds (after paying all other obligatory payments to the other “waterfall” parties).

The sharing ratio gives an indication of the degree of involvement of the said mezzanine tranche, thus affecting the decision as to whether or not to include it as part of “residual interest” consideration. In circumstances where the numerics are not clear, it is then necessary to consider together with the other indicators to arrive at a conclusion.

Issuance Date of this Consensus

7. This Consensus is issued on July 31, 2008. However, earlier application is encouraged.

References

- FRS 127 “Consolidated and Separate Financial Statements”
IC Interpretation 112 “Consolidation – Special Purpose Entities”

Illustrative Example 1 – Computation of majority benefits and risks of an SPE

An SPE is likely to be a subsidiary where the originator, in substance, has the right to obtain a majority of benefits or retains the majority of risks of the SPE’s activities.

When an entity measure the majority of benefits and risks in IC 112, it should take into consideration the entity’s exposure, before and after the transfer, with the variability in the amounts and timing of the cash flow of the transferred asset. This is illustrated as follows:

Benefits and risks before the transfer / pre transaction

Scenarios ⁽ⁱ⁾	(1) Present Value of future net cash flows ⁽ⁱⁱ⁾ RM'000	(2) Probability ⁽ⁱⁱⁱ⁾	(3) = (1)*(2) Weighted Present Value of future net cash flows RM'000	(4) = (1)- total of (3) Difference RM'000	(5) = (2)*(4) Probability weighted RM'000	Absolute data RM'000
Low loss	990	15%	148	11.05	1.66	1.66
Normal loss and few prepayments	985	20%	197	6.05	1.21	1.21
Normal loss	980	35%	343	1.05	0.37	0.37
Normal loss and many prepayments	970	25%	242.5	(8.95)	(2.24)	2.24
High loss	960	4.5%	43.2	(18.95)	(0.85)	0.85
Very high loss	950	0.50%	4.75	(28.95)	(0.15)	0.15
		100%	978.95		0	6.48

Benefits and risks after the transfer / pre transaction

Scenarios ⁽ⁱ⁾	(1) Present Value of future net cash flows ^(iib) RM'000	(2) Probability ⁽ⁱⁱⁱ⁾	(3) = (1)*(2) Weighted Present Value of future net cash flows RM'000	(4) = (1)- total of (3) Difference	(5) = (2)*(4) Probability weighted RM'000	Absolute data RM'000
Low loss	10	15%	1.5	(11)	(1.65)	1.65
Normal loss and few prepayments	15	20%	3.0	(6)	(1.20)	1.20
Normal loss	20	35%	7.0	(1)	(0.35)	0.35
Normal loss and many prepayments	30	25%	7.5	9	2.25	2.25
High loss	40	4.5%	1.8	19	0.85	0.85
Very high loss	40	0.5%	0.2	19	0.10	0.10
		100%	21		0	6.40

Comparison of absolute data pre and post transaction

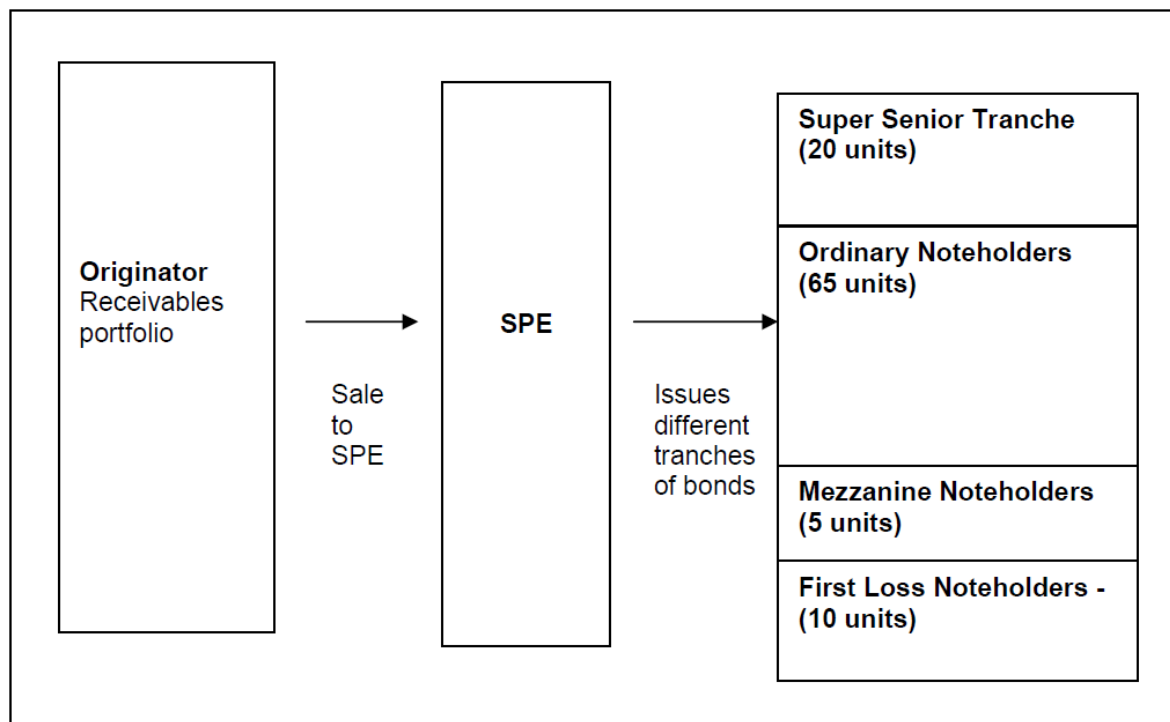
Post transaction / Pre transaction

= 6.40/6.48

= 99% - Retention of majority of risks and rewards from the receivables.

Explanatory note:

- i. This represents different expected outcome of the future net cash flows. The number scenarios should vary from one transaction to another.
 - (iia) This represents future discounted net cash flows before the transfer of the assets. The cash flows are derived from the assets to be transferred to the SPE e.g. collection from receivables.
 - (iib) This represents future discounted net cash flows after the transfer of the assets. The amount should be an aggregate of various cash flow streams like collection of servicing fees, cash arising from residual interest, reduced costs of borrowings and etc.
- ii. This represents the probability of each expected outcome of the future net cash flows.

Illustrative Example 2 – What constitute residual interest where there are different tranches of risk**Facts**

- The originator securitises its receivables portfolio to a SPE which then issues different tranches of bonds with different risk profiles:
 1. First loss of 10 units - borne by the First Loss Noteholders
 2. Next loss of 5 units - borne by Mezzanine Noteholders
 3. Next loss of 65 units - borne by Ordinary Noteholders
 4. Final loss of 20 units – borne by Super Senior Noteholders

- Given the above structure, in assessing the “benefit” indicator of IC112, there is the question of which component to include when considering residual interest?

- To determine the consolidation of SPE, IC 112 provides 4 indicators for consideration. One indicator explored whether the reporting entity, in substance, has rights to obtain a majority of the benefits of the SPE's activities through a statute, contract, agreement, or trust deed, or any other scheme, arrangement or device. Such rights to benefits in the SPE may be indicators of control when they are specified in favour of an entity that is engaged in transactions with an SPE and that entity stands to gain those benefits from the financial performance of the SPE.
- In respect of this indicator, IC112 provided an example where one needs to explore which entity/tranche holds the rights to majority residual interests in a scheduled residual distribution or in a liquidation of an SPE.
- Consideration should be given to the substance of the transaction. As usual, the residual distributions upon liquidations would follow a "waterfall" mechanism where the Super Senior tranche would have the first cut and flow the remainder to the next most senior tranche and so on. The last portion is known as the residual interest (after deducting the obligatory payments).
- Thus, the question is whether the residual interest consists of:
 - (i) The First Loss Noteholders tranche only or
 - (ii) The First Loss Noteholders and another tranche such as the mezzanine tranches.
- The evaluation should be on the distribution mechanism for the remaining proceeds (if any) after paying all obligatory payments to the other "waterfall" parties.
- Normally only the Originator tranche is entitled to the residual interest (if any). However, there may be instances where other tranches (for example the Mezzanine tranche) also partake in the residual interest. Thus, in the situation where another tranche, for example, the mezzanine tranche shares the remaining proceeds with the Originator, it is necessary to look at the sharing ratio to determine if Mezzanine tranche has the benefit of residual interest. For example, if there are 3 units remaining (residual interest) and both the Mezzanine and the Originator tranches share the said 3 units at a ratio of 50:50, there is a persuasive argument to include the Mezzanine tranche as part of the residual interest.

Conclusion

For the purpose of assessing the “benefits” indicator especially in respect of “residual interest”, other tranches such as mezzanine tranche should be taken into consideration together with the Originator tranche in situation where the said tranche has sharing arrangement with the Originator tranche in respect of the “residual interest” being the remaining proceeds (after paying all other obligatory payments to the other “waterfall” parties).

The sharing ratio gives an indication of the degree of involvement of the said mezzanine tranche, thus affecting the decision as to whether or not to include it as part of “residual interest” consideration. In circumstances where the numerics are not clear, it is then necessary to consider together with the other indicators to arrive at a conclusion.